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SUBJECT: MONTERREY ECONOMISTS PREDICT INFLATION; NUEVO LEON CUTS BUDGET

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MONTERREY 00000304 001.2 OF 003

¶1. (SBU) Summary: Two noted Monterrey economists cautioned about a potential rise in inflation when the Mexican economy finally begins to rebound, which one economist predicted would occur over the next two to three quarters. Both believed overall year-end GDP would post a significant decline. Meanwhile, the state of Nuevo Leon recently announced additional austerity measures that will include cutbacks on top officials' salaries and on operating hours at non-essential state offices. One economist told EconOffs that he believed the economic decline had halted, and criticized GoM tax reforms and handling of oil revenues. If the economy does recover soon, the strength of that recovery will be dependent on the viability of the U.S. economic recovery and the impact of any H1N1 influenza resurgence in the fall. End summary.

Economic Downturn May Have Halted

¶2. (SBU) At a recent meeting with EconOffs, noted Monterrey economist Salvador Khalifa forecast that economic conditions in Mexico will improve over the next 2 - 3 quarters. However, the sustainability of a Mexican rebound will depend on the strength of the U.S. economic recovery. The recent rise in the Mexican stock market, he cautioned, should not be viewed as a bellwether that the domestic economic climate is improving yet, since many multinational companies are listed on the exchange. Smaller domestic companies, with fewer resources, were more deeply impacted by the recession and will take longer to recover, he noted.

¶3. (SBU) At a separate meeting, Agustin Del Rio, Bank of Mexico (central bank) representative in Monterrey, relayed that the economic situation in the Mexican border states was still dismal. He pointed out that, despite recent reports indicating a slight rise in employment in Nuevo Leon, job losses across the country continue to surprise economists.

GDP Predictions

¶4. (SBU) Khalifa predicted that Mexico's 2009 GDP would post a 7 to 8 percent decline. This figure is roughly in line with the Bank of Mexico's latest projection of a GDP decline of 6.5 to 7.5 percent and slightly higher than the State of Nuevo Leon's Secretariat of Economic Development (SEDEC) forecast of a 6.3 percent drop (ref A). Del Rio was more pessimistic, claiming GDP could be down as much as 9 percent by year end.

Inflation on the Horizon?

¶5. (SBU) Khalifa forecast an increase in inflation, currently at 5.74 percent per June Bank of Mexico figures, as the recession ends and companies raise prices in an attempt to recoup losses. In support of his prediction, he referred to a steep yield curve for Mexican debentures.

¶6. (SBU) Del Rio concurred that inflation could be a future threat. However, he pointed to central bank policy as a contributing factor. He explained that two camps have formed on the bank board. One side, which is prevailing currently, believes the central bank has to keep lowering interest rates to stimulate the economy. The other side believes that since banks still are not lending, lowering rates will not open a tight credit market.

¶7. (SBU). Del Rio opined that lower interest rates could lead to additional devaluation of the peso against the dollar, which could help fuel inflation. He added that he did not believe the

central bank planned any future currency interventions. Currency speculation has declined, he noted, due to the size of Mexico's currency reserves and the availability of IMF and USG lines of credit.

GoM Cash Strapped

¶8. (SBU) Mexico has "no (fiscal) room to maneuver" Khalifa explained, because the GoM has already spent the majority of the revenue it received when petroleum prices were high. As an example, he noted that Mexico's percentage of foreign reserves to GDP was significantly lower than that of other countries that had benefitted from the oil price boom, such as Russia. Khalifa was alarmed that, instead of showing fiscal restraint, the government has increased its size and expenditures during the current recession.

¶9. (SBU) Khalifa pointed out that to formulate its annual budget for 2009, the GoM purchased options to guarantee a price of at least US$ 70 per barrel of oil. While the government's hedge could appear prudent if oil prices end below that figure, the aggregate cost of buying these options over the past few years has negated any current financial benefit, he claimed.

Nuevo Leon Fiscal Crunch

¶10. (SBU) The states, beneficiaries of GoM revenue sharing, have not fared any better, Khalifa noted. Nuevo Leon, for instance, spent its increased funding on big ticket items such as construction of the Santa Lucia Riverwalk project and hosting the 2007 Universal Forum of the Cultures, but did not retain any of the funds in reserve.

¶11. (SBU) Indeed, on July 27, Nuevo Leon's Secretary of Finance and General Treasury Ruben Martinez Donde pointed to a reduction in GoM revenue sharing as the root cause behind a US$ 19.5 million austerity plan that would mandate a 30 percent reduction in the salaries of top state officials. Other measures included a cutback on the hours of operation of non-essential state agencies and suspension of any projects not "100 percent" completed.

¶12. (SBU) Martinez was particularly concerned about the financial condition of rural municipalities, which he said were "practically broke" since they rely wholly on state funding. This austerity plan follows on the heels of an earlier reduction in the state budget of around US$ 113 million. Media reports since have criticized the state government for increasing expenditures prior to the July election.

Taxes Questioned

¶13. (SBU) The GoM 'flat tax' on corporate revenue was of particular concern to Khalifa. The tax is levied on the net difference between current year corporate revenues and expenses, but does not take into account prior year expenditures. Many companies left with excess inventory during the recession will be penalized as they begin to sell off inventories after the economy recovers, since inventory expenses from previous years cannot be expensed from gross current year revenues, he explained. The result will be disproportionately high corporate tax liabilities that will hobble Mexican companies' global

competitiveness. Nevertheless, Khalifa did not concur with maquila association concerns that federal lawmakers will raise taxes on the industry to increase government revenue (ref B).

Economy Hurt by H1N1 Flu Outbreak and Holy Week Closures

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¶14. (SBU) The virtual shut down of the country during Holy Week and, later, in response to the H1N1 influenza outbreak, contributed to the economy's dismal performance in the second quarter, Khalifa noted. He said that another influenza outbreak in the fall could have an equally devastating effect on overall economic recovery. Khalifa accused the GoM of overreacting to the outbreak in May by closing Mexico's major cities. He did not believe the government is more prepared for a new outbreak and will likely resort to the same blunt measures.

Comment

¶15. (SBU) As in any attempt to forecast the economic future, economists hold a wide variety of opinions. The general consensus among those that post has met with is that the Mexican economic decline has halted for the time being and may begin to recover in the near future. Given the close economic ties between Nuevo Leon and the U.S., the strength of that recovery will be dependent on a U.S. economic rebound. Although they could not agree on the final figures, the economists concurred that Mexico will post a substantial year-end GDP drop. The wild card in the economic recovery scenario remains the severity of a possible H1N1 influenza resurgence in the fall. While employment and other macro economic factors appear somewhat stronger in Nuevo Leon, the state is clearly experiencing an economic shock that will take some time to remedy.
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